Lehman Brothers Holdings Inc.
6 Month Period Ended May 31, 2008
Mortgage Capital Team: Principal Transactions P&L Review

The purpose of this memo is to document the quarterly Principal Transactions P&L review performed by the Mortgage Capital Team for the reporting period ending May 31, 2008 and to document the analytical review performed by the team as part of our quarterly review in accordance with Statement of Auditing Standards No. 100, *Interim Financial Information*. A tabular presentation of the P&L data being analyzed in this memo is shown below. Note that the amounts referenced in this table include the areas for which the EY Mortgage Capital Team have responsibility and are derived from the quarterly Greenbook management report and Lehman's general ledger system as provided by Lehman Brothers via the EY Corporate Team..

E&Y met with the following Lehman contacts to gain an understanding of the quarter and year to date revenues. Additionally, we made inquiries of these individuals with respect to significant items and/or fluctuations from the comparable periods in the prior year and the trailing period. *(Note: all $ balances in this memo are in millions unless otherwise noted)*:

<u>Overall FID</u> – Clement Bernard (FID CFO and Managing Director)
<u>Commercial Real Estate</u> – Jonathan Cohen (SVP), Abe Kebede (VP), and Anish Patel (VP)
<u>Securitized Products</u> – Jim Guarino (SVP), Gary Belitz (VP), Joe Sapia (VP), and Dirk Haseruck (VP)
<u>Governments</u> – Scott Goswami (SVP) and Alice Zhang (VP)
<u>FID Prime Services</u> – Sven Farup (SVP) and Len Scicutella (SVP)

Overall Analysis of Principal Transactions P&L

	Quarter Ended *5/31/2008*	Quarter Ended *5/31/2007*	$ Difference	% Difference	Quarter Ended *2/29/2008*	$ Difference	% Difference
Fixed Income Cash							
Real Estate	$ (1,520)	$ 407	$ (1,927)	-100+%	$ (1,100)	$ (884)	-100+%
Securitized Products	$ (2,035)	$ 48	$ (2,083)	-100+%	$ (636)	$ (935)	-85%
Governments	$ 8	$ 64	$ (56)	-88%	$ 149	$ (141)	-95%
FID Prime Services	$ (54)	$ 34	$ (88)	-100+%	$ 73	$ (127)	-100+%

	6 Months Ended *5/31/2008*	6 Months Ended *5/31/2007*	$ Difference	% Difference
Fixed Income Cash				
Real Estate	$ (2,620)	$ 737	$ (3,357)	-100+%
Securitized Products	$ (2,671)	$ 230	$ (2,901)	-100+%
Governments	$ 157	$ 146	$ 11	8%
FID Prime Services	$ 19	$ 83	$ (64)	(77)%

1. Real Estate

Revenues from Commercial Real Estate ("CRE") for the quarter ended May 31, 2008 resulted in a loss of \$1.5bn, down \$1.9bn from a \$400mm gain in Q2 '07 and \$420mm from a \$1.1bn loss in Q1 '08. Continued declines in CRE revenues are the result of a combination of significant reductions in deal activity and valuation deterioration in certain areas in the US and Europe as market conditions and the lack of liquidity continue to negatively impact the commercial real estate markets. While the 2nd Quarter of 2008 saw increased activity of asset sales, transaction prices continue to reflect lower market valuations due to market liquidity and risk premiums associated with CRE financing. Quarterly losses primarily reflect the impact of continued write-downs across multiple areas of the CRE portfolio in both the US and Europe and losses on positions entered into with the intent of economically hedging the CRE portfolio.

Quarter Ended		5/31/2008	5/31/2007	$ Change	% Change	2/29/2008	$ Change	% Change
US								
	PTG	$ (445)	$ 122	$ (567)	-465%	$ (306)	$ (139)	45%
	Commercials	$ (845)	$ 136	$ (981)	-721%	$ (393)	$ (452)	115%
	CMBS Securities	$ (11)	$ 3	$ (14)	-467%	$ (79)	$ 68	-86%
	Total US	$ (1,301)	$ 261	$ (1,562)	-598%	$ (778)	$ (523)	67%
Europe								
	PTG	$ (1)	$ 106	$ (107)	-101%	$ (43)	$ 42	-98%
	Commercials	$ (80)	$ 28	$ (108)	-386%	$ (193)	$ 113	-59%
	NPL	$ (3)	$ (1)	$ (2)	200%	$ (4)	$ 1	-25%
	Total Europe	$ (84)	$ 133	$ (217)	-163%	$ (240)	$ 156	-65%
Asia								
	PTG	$ 31	$ 55	$ (24)	-44%	$ 21	$ 10	48%
	Commercials	$ 14	$ 29	$ (15)	-52%	$ 30	$ (16)	-53%
	NPL	$ (1)	$ 20	$ (21)	-105%	$ 10	$ (11)	-110%
	Total Asia	$ 45	$ 104	$ (60)	-57%	$ 61	$ (17)	-27%
	SUB TOTAL	**$ (1,341)**	**$ 498**	**$ (1,839)**	**-369%**	**$ (957)**	**$ (384)**	40%
Plus (Minus): Net Interest		$ (179)	$ (91)	$ (88)	97%	$ (143)	$ (36)	25%
TOTAL PRINCIPAL TRANS		**$ (1,520)**	**$ 407**	**$ (1,860)**	**-473%**	**$ (1,100)**	**$ (420)**	38%

The business took write-downs across the commercial real estate portfolio during the quarter. The table below summarizes the global write-downs (which are included in the numbers outlined above):

Description/Region	**Mark downs**
US	
PTG Land and Condos (CA)	(325)
PTG Land and Condos (excluding CA)	(148)
Other PTG	(7)
Commercial Whole Loans & CMBS	(194)
Bridge Equity	(349)
	(1,023)
Europe	
PTG	(16)
Commercial Whole Loans & CMBS	(62)
	(78)
Asia	(2)
TOTAL	**$ (1,103)**

1.1. *Commercials & CMBS*

Commercials are primarily comprised of conduit and large loans with a principal exit strategy, historically of sale, namely securitization. However, given the significant changes in the marketplace throughout 2007 and into 2008, Lehman completed only one securitization during Q2 In the U.S., Q2 '08 results were well below those of Q2 '07, but slightly improved from Q1 '08 as the declining prices observed by traders in the market continued to create downward mark-to-market adjustments. Similar to US markets, European CRE markets continue to experience market liquidity dislocations and increased risk premiums that resulted in Q2'08 losses greater than both Q2'07 and Q1'08. Notably, losses in Europe are concentrated in structured CMBS transactions and a specific group of large PTG assets. Asia continued to produce small gains during the quarter, though down from revenues posted in both Q2'07 and Q1'08, as the Asian commercial real estate market remained stable relative to other CRE markets during the quarter.

Significant items (greater than $10mm of gain/loss) recognized during Q1 '08 include the following (Note: All items below are mark-to-market write-downs):

Deal Name	Gain/(Loss)
US	
Rosslyn B Note	$ (20)
Wyndham	(14)
Hancock Mezz	(13)
LBUBS C1-08	(10)
Rosslyn B Note	(20)

Deal Name	Gain/(Loss)
Europe	
City Lofts EUR	(34)
Windemere Bonds	(21)
Centrum Komaniet	(15)
Green	24
Asia	
Project Cowboy	(14)
Kajima	21

1.2. *PTG*

PTG is primarily comprised of loans to independent developers or equity interests in partnerships with independent developers to invest in large single assets. Revenues in the business continued to decrease significantly during Q2 '08 relative to Q2 '07 and Q1 '08. The fall in revenues is due in large part to the continuing downturn in various commercial real estate markets, fueled by the credit and liquidity issues experienced throughout the financial markets. Additionally, market supply and demand dislocations resulting from residential markets has impacted PTG financing assets related to certain land and condo developments. Further, PTG financing assets related to classes such as office and hotel properties also continue to be impacted by macroeconomic factors and broad economic market uncertainties. Several valuation write-downs were taken during the quarter in response to the market movements, totaling over $829mm in losses related to PTG assets and bridge equity investments. Further, the large decrease from Q2'07 is the result of a number of transactions that produced gains occurring in the comparable quarter of the prior year, while decreases from the consecutive quarter continue to be responsive to market risk and liquidity concerns.

Significant items (greater than $10mm of gain/loss) recognized during Q1 '08 include the following (Note: All mark-to-market write-downs):

Deal Name	Gain/(Loss)
Archstone Syndication LP	$ (289)
Suncal Portfolio	(178)
Troxler Portolfio	(130)
PLF Syndication LP	(40)
Indianatown	(30)
Whitworth Estates	(20)
LB Maple Stephenson	(15)

See separate memo on Archstone and Suncal position reviews.

1.3 Balance Sheet

	5/31/2008	2/29/2008	$ Change	% Change	11/30/2007	$ Change	% Change
US							
PTG	$10,701	$11,901	(1,200)	-10.08%	$11,773	(1,072)	-9.11%
Commercials	22,241	24,736	(2,495)	-10.09%	25,557	(3,316)	-12.97%
CMBS Securities	578	965	(387)	-40.10%	1,424	(846)	-59.41%
	33,520	37,602	(4,082)	-10.86%	38,754	(5,234)	-13.51%
Europe							
PTG	4,980	3,098	1,882	60.75%	1,123	3,857	343.46%
Commercials	11,536	14,068	(2,532)	-18.00%	16,183	(4,647)	-28.72%
NPL	55	53	2	3.77%	65	(10)	-15.38%
	16,571	17,219	(648)	-3.76%	17,371	(800)	-4.61%
Asia							
PTG	2,864	2,388	476	19.93%	2,440	424	17.38%
Commercials	4,164	5,061	(897)	-17.72%	4,178	(14)	-0.34%
NPL	2,187	2,152	35	1.63%	1,880	307	16.33%
	9,215	9,601	(386)	-4.02%	8,498	717	8.44%
TOTAL	**$59,306**	**$64,422**	**(5,116)**	**-7.94%**	**$64,623**	**(5,317)**	**-8.23%**

Consistent with Lehman's press releases following Q1, the business undertook an initiative to actively sell down assets from the CRE balance sheet. As a result, originations were at record lows while the business actively drew down the balance sheet exposure by approximately $5B, net of write-downs. The Asia balance sheet decreased from the prior period due to sales, as noted above, and below-average origination volume.

1.4 Other P&L

During Q2 '08, Lehman recorded losses of approximately $112mm related to real estate advisory service which are presented in the Investment Banking revenues line item on the quarterly income statement. This business line continues to be negatively impacted by the marketplace, as Lehman also incurred losses of approximately $202mm related to real estate advisory service revenues in Q1 '08. The continued underperformance relative to historical revenues is due to the changes in securitization markets, as outlined above, and minimal origination volumes during the quarter combined with below-par, at-market sales during the quarter

Beginning in 2007, Lehman's CRE division began actively hedging certain portions of its balance sheet exposure through dynamic hedging strategies. Throughout the life of these hedges, the hedge performance had created offsetting gains to the underperformance of the division's cash CRE assets. However, in 2Q'08, dislocations in the credit markets, combined with non-parallel movements of spreads, created hedge inefficiencies that resulted in net hedge losses of approximately $223MM, compared to immaterial net hedge P&L from both the consecutive and the year-ago period.

2. Securitized Products

Securitized products principal transactions revenues in Q2 '08 were down compared to Q1 '08 and Q2 '07 results. The decrease is primarily attributed to the industry-wide weakening of the US residential mortgage sector that started in early 2007 and continues to affect the capital markets.

Principal Transactions	**Quarter Ended 5/31/08**	**Quarter Ended 2/28/08**	**$ Change**	**% Change**		**Quarter Ended 5/31/07**	**$ Change**	**% Change**
Securitized Products Trading	$ (1,412)	$ (280)	$ (1,132)	-404%		$ 218	$ (1,630)	-748%
Securitized Products Origination	(147)	(60)	(87)	-145%		71	(218)	-307%
Total Securitized Products	**$ (1,559)**	**$ (340)**	**$ (1,219)**	-359%		**$ 289**	**$ (1,848)**	-639%

2.1 Sub-prime and Prime Trading

As a result of the continued downturn in the subprime market, Lehman recorded additional mark-downs of $669mm (Q1 = $728mm) on its sub-prime portfolio. The Q2 write-down of $669mm is mainly attributable to losses on bond positions (including NIMs and residuals) of $381mm and first and second lien whole loan positions of $288mm. This brings the total write-down to $3,534mm since the market deterioration was started to be felt in early 2007. This write-down was partially offset by Lehman's gains on sub-prime mortgage-related derivatives, primarily ABX trades and single name credit default swaps, totaling $294mm (Q2 = $620mm). ABX 07-2 spreads on AAA ABS have continued to widen from 633bps to 952bps during the second quarter.

The "trickle-down effect" of the sub-prime crisis had also affected the prime portfolio and higher-rated securities as the liquidity in this asset class continues to decline. Spreads on agency and prime conventional fixed 30 year products have narrowed slightly from approximately 111.2bps at 2/29/08 to 100.3 at 5/31/08. Price observability was evident, as the sale of Peloton Fund assets that were taken over by the repo desk and subsequently sold by the mortgage desk during the beginning of the quarter while the business continued to execute whole loan sales, with observability continuing through the end of May Most notably, the business executed agency deliveries and trades with non-agency counterparties as well as completed and sold significant pieces of a private placement subprime/scratch & dent/non-performing loan securitization with a notional of $1.6bn. During Q2 '08, Lehman recorded additional write-downs on its prime portfolio of $890mm as compared to $1,407 in Q1 '08. These write-downs are primarily attributable to bond positions (including residuals) of $414mm and prime whole loans of $476mm. This brings the total write-down on prime products to $4.055mm since Q1 '07. The Q2 write-down was partially offset by Lehman's P&L on prime mortgage-related derivatives, primarily single name credit default swaps, of $28mm (vs. $334mm in Q2 '08).

Lehman also booked additional residential loan related reserve expenses in Q208 as a result of continuing deterioration in collateral performance and counterparties (brokers and correspondents) going out of business. These reserves relate to early terminations, first payment defaults, and breaches on representations and warranties. Lehman started to ramp up its residential loan related reserves in 2007 when several correspondence banks started to exit the marketplace and delinquencies started to rise as a result of the credit crisis. The reserves on balance sheet at Q2 '08 totaled $356mm.

Lehman's global origination volumes were down during Q2 '08 (63% vs. prior quarter and 96% vs. prior year comparable period) as a result of Lehman's decision to exit the sub-prime and wholesale prime origination business in late 2007 and early 2008, respectively.

Lehman posted net securitization losses of ($43mm) in its residential securitization deals for the quarter as securitizations volume and spreads continue to decline. See below for details:

2.2 Securitizations

Securitization Trending

	Q2 '08	Q1 '08	Q4 '07	Q3 '07	Q2 '07	Q1 '07
Securitization Revenue	($43)	($32)	($127)	$19	$ 173	$ 106
Securitization Volume	$10,068	$7,576	$25,190	$37,299	$ 56,289	$ 42,513
Securitization Margin/Spreads	-43 Bps	-42 Bps	-50 Bps	5 Bps	31 Bps	25 Bps

Securitization Details – Notional

Type	Notional					
	Q2 '08	Q1 '08	Q4 '07	Q3 '07	Q2 '07	Q1 '07
Agency CMO	$ 4,616	$ 4,450	$ 2,863	$ 8,049	$ 13,031	$ 5,834
Prime Securitization	1,142	1,385	4,378	10,849	16,823	12,570
Option ARMS	-	-	982	5,763	6,123	3,620
Non-Prime Securitization	891	1,701	1,267	1,143	5,602	4,909
Europe	3,148	-	2,920	3,276	1,151	6,312
Asia	-	-	270	-	-	-
Reverse Mortgage	220	-	-	-	701	-
Scratch & Dent	52	-	867	179	478	296
LBSBC	-	40	700	529	353	29
Syndicate MB	-	-	10,943	7,511	12,027	8,943
Total	**$ 10,068**	**$ 7,576**	**$ 25,190**	**$ 37,299**	**$ 56,289**	**$ 42,513**

Securitization Details – Revenues

Type	Flash					
	Q2 '08	Q1 '08	Q4 '07	Q3 '07	Q2 '07	Q1 '07
Agency CMO	$ 8	$ 7	$ 2	$ 8	$ 18	$ 6
Prime Securitization	(9)	16	4	3	42	34
Option ARMS	-	-	(22)	(20)	17	18
Non-Prime Securitization	-	(55)	(36)	9	16	6
Europe	(42)	-	(62)	(9)	39	29
Asia	-	-	19	-	-	-
Reverse Mortgage	-	-	-	-	5	-
Scratch & Dent	-	-	-	25	18	5
LBSBC	-	-	(33)	-	11	-
Syndicate MB	-	-	1	3	7	8
Total	**($ 43)**	**($ 32)**	**($ 127)**	**$ 19**	**$ 173**	**$ 106**

2.3 Balance Sheet

			Increase (Decrease)	
	5/31/08	**2/29/08**	**Amount**	**%**
Whole loans	$ 6,111	$ 8,967	($2,856)	-32%
Securities (including residuals)	12,920	16,581	(3,661)	-22%
FAS 140 gross-up	9,071	7,200	1,871	26%
Servicing	1,697	1,489	208	14%
Agency CMOs	7,860	6,006	1,854	31%
LBSF Derivatives	6,375	3,783	2,592	69%
Others	1,768	1,463	305	21%
Americas	**45,802**	**45,489**	**313**	**1%**
Whole loans	1,748	4,558	(2,810)	-62%
Securities	7,594	4,886	2,708	55%
FAS 140 gross-up	1,262	945	317	34%
Others	627	874	(247)	-28%
Europe	**11,231**	**11,263**	**(32)**	**0%**
Whole loans	556	329	227	69%
Securities	178	370	(192)	-52%
Others	1,102	1,195	(93)	-8%
Asia	**1,836**	**1,894**	**(58)**	**-3%**
Total Securitized Products	**$ 58,868**	**$ 58,646**	**$222**	**0%**

The securitized products balance sheet increased by $222 million globally from 2/29/2008, largely as a result of an increase in FAS 140 gross-up. Changes in "Securities" and "LBSF Derivatives" lines represent reclassifications of ABS securities between BPM lines and do not represent true balance sheet changes. The increase is attributed mostly to the Americas balance sheet. No significant movement in Europe and Asia balance sheet levels.

3. Governments

Governments Principal transactions revenues were $8MM, down from $149MM in Q108 and $64MM in Q207. The decrease in gains was primarily due to weakened results from the US governments desk And European governments desk as both desks produced lower results in excess of $80MM, respectively. During the second quarter, Europe was hurt by accelerated changes in the market's view on inflation and ongoing economic concerns which had negative impacts on negatively impacted positions such as GBP futures.. The results in the US governments desk was due to a decrease from record client volumes and flow business experienced in the first quarter. The Asian governments desk remained slightly down from the previous quarter and the year-ago period at $15.8MM in Q208, 22MM in Q108, and $23.4MM in Q207.

4. FID Prime Services

The FID Prime Services business consists of liquid markets, credit and emerging markets ("EMG") financing. These businesses produced losses of $54MM in Q208, compared to gains of $73MM in Q108 and $34MM in 2Q07. Decreases are due to decreased customer volume, services, and fees given the changes in the marketplace and continued operating expenses in the division.

Control Update

During the meetings highlighted on page 1 of the memo, we made inquires of Lehman personnel regarding changes in controls in each area. No significant items were noted. Further, we obtained price verification schedules and other files evidencing controls such as the quarterly pricing report and management reports analyzing quarterly P&L. Based on a review of these reports, we believe the controls continue to function in a manner consistent with that as of November 30, 2007.